Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Frommer	Analyst:	Gail Hall	Bill Number:	AB 2998
Related Bills:	See Legislative History	Telephone:	845-6111	Introduced Date:	February 24, 2006
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Limitations/Exclusions Applied On A Post-Apportionment Basis

SUMMARY

This bill would apply the method of calculating California taxable income to certain federal limitations[1] and exclusions[2] conformed to by California.

PURPOSE OF THE BILL

The purpose of this bill is to provide clarity regarding the application of certain federal limitations and exclusions with the California method of taxing multistate corporations, which apportions income among the states.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and if enacted in 2006, apply to taxable years beginning on or after January 1, 2006.

POSITION

On December 7, 2005, the Franchise Tax Board voted 2-0, with the representative from the Department of Finance abstaining, to sponsor the provisions of this bill.

ANALYSIS

Federal/State Law

1. **Internal Revenue Code (IRC) Section 382 – Limitation On Net Operating Loss (NOL) Deductions Following An Ownership Change**

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[1] Internal Revenue Code (IRC) Sections 382 and 383.
[2] IRC Section 108.

Board Position:			Department Director	Date
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SA	O	NAR	S. Stanislaus	4/25/06
N	OUA	PENDING		

Federal Law

When a corporation has a net taxable loss for the tax year, the net taxable loss is called an NOL. An NOL may be carried forward to future tax years and taken as a deduction to reduce taxable income or carried back to prior tax years and deducted to reduce taxable income for the prior year.

When a corporation acquires another corporation with NOLs, federal law limits the amount of acquired NOL the buyer may deduct on its tax return each year. This limitation is referred to as the “Section 382 limitation.” The Section 382 limitation does not allow the buyer to use the NOLs at a faster rate than the acquired corporation could have used them if it had sold its assets and invested the proceeds in tax-exempt government obligations. The purpose of this rule is to make NOLs a neutral factor in a corporate acquisition. Prior to the enactment of this limitation, corporations with large NOLs were being purchased by corporations with large taxable incomes simply because the acquired corporation’s NOLs could be used to reduce the buyer’s taxable income.

The Section 382 limitation is calculated by multiplying the fair market value of the stock of the acquired corporation immediately prior to the change in ownership by the federal long-term tax-exempt rate. The Internal Revenue Service publishes this rate monthly.

For example:

Buyer corporation purchases at fair market value all of the stock of Target corporation for $1,000,000. Target has a $500,000 NOL. The long-term tax-exempt bond rate is 10%. The amount of Target's NOL that Buyer may deduct each year is limited to $100,000 ($1,000,000 x 10%) until the total acquired $500,000 NOL is used up.

State Law

California generally determines its NOL in accordance with the federal rules but has several differences. One difference is that the California NOL is calculated by taking the corporation’s federal net taxable loss, after applying certain state adjustments, and multiplying this number by the California apportionment percentage to calculate the California NOL.

For example, if a corporation has a federal net taxable loss after state adjustments of $1,000,000 and has a California apportionment percentage of 20%, the corporation's NOL for California is $200,000. ($1,000,000 x 20%). For federal purposes the NOL is $1,000,000, but for California purposes an additional step of multiplying the NOL by an apportionment percentage is necessary to determine the corporation's proper or proportionate NOL for California.

California conforms to the Section 382 limitation on NOLs.

2. IRC Section 383 – Limitation On Tax Credits Following An Ownership Change

Federal Law

When a corporation acquires another corporation that has unused carryover tax credits, federal law limits the amount of the acquired tax credits the buyer may claim on its tax return each year. This limitation is referred to as the "Section 383 limitation." As with the Section 382 limitation, the purpose of this rule is to make tax credits a neutral factor in a corporate acquisition and prevent corporations with large taxable income from purchasing corporations with large tax credits in order to reduce their tax liability.

The Section 383 limitation is calculated using the Section 382 limitation. The Section 383 limitation is calculated by taking the excess Section 382 limitation, if any, and multiplying this number by the acquired corporation's federal marginal tax rate.

For example:

Corporation A is acquired and subject to the Section 382 limitation. The Section 382 limitation is $25,000, and Corp A's acquired NOLs equal $20,000. After applying the Section 382 limitation, Corp A's acquired NOLs may be fully deducted, and there is an excess of $5,000 available for the Section 383 limitation ($25,000 - 20,000). Corp A's marginal tax rate is 15%, so the Section 383 limitation is calculated to be $750 ($5,000 x 15%). If Corp A had unused carryover tax credits that were acquired, only $750 of these credits could be taken in the acquisition tax year. This calculation is performed each year until Corp A's acquired tax credits are exhausted.

State Law

California conforms to the Section 383 limitation on tax credits.

3. IRC Section 108 – Cancellation of Indebtedness

Federal Law

When a borrower has its debt repayment obligation cancelled that borrower must include in federal taxable income the amount of debt cancelled. Various exceptions to this immediate income recognition rule are contained in federal law[3]. One exception provides that instead of including the amount of cancellation of indebtedness in taxable income, the corporation may instead reduce certain tax attributes that could have been used to reduce the tax liability of that corporation in future years. These tax attributes include NOLs, tax credits, capital losses, and the depreciable basis of property. Tax attributes such as NOLs, capital losses, and "depreciable basis" are reduced dollar for dollar, while tax credits are reduced at 33 1/3 cents per dollar of income not recognized.

[3] IRC Section 108.

For example:

A corporation has $500,000 of its debt cancelled and excludes this income under Section 108. The corporation has an NOL carryforward of $600,000. The corporation may exclude the $500,000 of cancelled debt from taxable income, but must reduce its NOL carryforward to $100,000 ($600,000 - $500,000).

State Law

California conforms to Section 108 with modifications.[4] One modification is that tax credits are reduced at 11.1 cents per dollar rather than the 33 1/3 cents for federal law.

PROGRAM BACKGROUND

A corporation files or is included in one federal tax return, but a corporation may file or be included in numerous state tax returns. To divide up the federal taxable income among the states, many states use an apportionment percentage to determine how much of the federal taxable income, i.e., business income, is taxable in each state. The California apportionment percentage is determined on the basis of a formula. This formula measures relative levels of business activity in the state using the amounts of the taxpayer's property, payroll, and sales in California. These measures of activities are commonly called "factors."

California conforms to the federal provisions that allow a corporation to exclude from taxable income the amount of the corporation's indebtedness that is cancelled as long as the corporation reduces certain tax benefits called "tax attributes" by the same amount as the debt cancelled. Examples of tax attributes are NOLs and tax credits. California law does not specify whether the apportionment percentage is applied to the corresponding federal exclusion of cancellation of indebtedness income to arrive at the amount of tax attributes that are required to be reduced for California.

California conforms to the federal provisions relating to corporations that acquire other corporations with NOLs and tax credits and the limitation on the amount of acquired NOLs and tax credits that may be taken each year. California law does not specify whether the corporation's apportionment percentage is applied to the federal limitations on acquired NOLs or tax credits.

THIS BILL

This bill would add provisions to current law that limit the usage of NOLs and tax credits from acquired corporations by taking the federal limitation on acquired NOLs and multiplying it by the average of the acquired corporation's California apportionment percentages for the year of the acquisition and the two immediately preceding tax years.

In addition, this bill would add provisions to current law that the apportionment and allocation rules would apply to the excluded cancellation of indebtedness income to determine the amount

[4] R&TC Section 24307.

of tax attributes[5] required to be reduced for California. See Appendix A for the application of these rules.

This bill is consistent with the unpublished opinion of the California State Board of Equalization, *Appeal of Wilshire Restaurant Group, Inc.*.

LEGISLATIVE HISTORY

There has been no prior legislation similar to AB 2998.

OTHER STATES' INFORMATION

The laws of *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York* were reviewed because their tax laws are similar to California's income tax laws. One similarity is that these states use an apportionment percentage to assign income for state purposes.

IRC Section 382 NOL limitation

Florida, Illinois, and *New York* generally conform to Section 382, but it could not be determined whether the NOL limitation is calculated before apportionment or after apportionment.

Massachusetts determines its Section 382 NOL limitation by multiplying the federal limitation by *Massachusetts* taxable net income divided by federal taxable income.

Michigan does not conform to Section 382, and *Minnesota* issued a revenue notice explaining that the federal "Section 382 limitation" is multiplied by the *Minnesota* apportionment factor to determine the NOL limitation for *Minnesota*. This method is similar to this proposal.

IRC Section 383 Tax Credit Limitation

Illinois, Michigan, Minnesota, and *Massachusetts* generally conform to Section 383, but research did not confirm that *Florida* and *New York* conform to this provision.

IRC Section 108 Cancellation of Indebtedness

The states reviewed generally conform to Section 108, but it could not be determined whether the amount determined to reduce tax attributes is calculated before apportionment or after apportionment.

A general search of all states showed that *Oregon* implemented a regulation to address the reduction of tax attributes for the Section 108 exclusion of cancellation of indebtedness income. The regulation provides the following rules:

- Tax credits are not subject to tax attribute reduction,

[5] I.e., depreciable basis, NOLs, and tax credits.

- Excluded cancellation of indebtedness income is first multiplied by the Oregon apportionment factor to determine the amount of reduction required for tax attributes, and
- "Basis of property" is reduced before apportionment.

Oregon's regulation is similar to this proposal in that it applies the apportionment percentage to the amount of excluded cancellation of indebtedness income before determining the amount of tax attributes to be reduced.

FISCAL IMPACT

This bill would not significantly impact the department's programs and operations.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Based on data and assumptions discussed below, the revenue impact from this bill would be as follows:

Estimated Revenue Impact of AB 2998 Effective for taxable years on or after 1/1/2006 Fiscal Year Impact (in Millions)		
2006-07	**2007-08**	**2008-09**
$27	**$18**	**$9**

<u>Revenue Discussion</u>

<u>Federal NOL and Tax Credit Limitations</u>

This bill would apply the apportionment and allocation rules to the federal limitations relating to NOLs and tax credits from acquired corporations to determine the limitation for California. This may result in a reduction in the amount of NOLs and tax credits the acquired corporation is allowed to deduct in the first taxable year after the acquisition and also in each subsequent tax year until the NOLs and tax credits are "exhausted." To the extent that the NOLs and tax credits that are limited each year can be used in later years, the revenue impact is an "acceleration" rather than a long-term revenue gain.

The data for determining the amount of the federal NOL limitation on acquired corporations with California NOLs is not available. The revenue estimate was based on data available on California NOLs and the apportionment percentage of the acquired corporations.

In 2001, corporations reported approximately $2.1 billion more in available California NOL carryovers than would have been predicted from their available California NOL carryovers reported at the end of 2000. Based on audit data, it is estimated that 47% of the $2.1 billion of excess NOLs ($987 million) can be attributed to acquisitions. Using the apportionment factors from the acquired corporations with excess NOLs, it was determined that 46% of the $987 million of excess NOLs from acquired corporations, or $454 million, may not be able to be used immediately because of the proposal's new California limitation. Of this $454 million, it is estimated that 50%, or $227 million, of the NOLs would not be allowed immediately but may be used in subsequent tax years. Applying an average tax rate of 5.3%, it is estimated that this limitation would result in increased revenues by approximately $12 million ($227 million x 5.3%) for calendar year 2001. Adjusting for growth of NOLs generated and the effects due to the suspension of NOLs for taxable years 2002 and 2003, the revenue impact for 2006 is estimated to be $22 million. The estimate assumes that 95% of the limited NOLs will be used in the following three tax years.

In 2003, corporations reported on their tax returns approximately $385 million more in California tax credits than the tax credit carryovers reported on their tax returns at the end of 2002. It is estimated that 70% of the $385 million of excess tax credits, or $270 million, can be attributed to acquisitions. Using the apportionment factors from the acquired corporations with excess tax credits, it was determined that approximately 18% of the $270 million of excess tax credits from acquired corporations, or $48 million, may not be able to be used immediately because of the proposal's new California limitation. Of this $48 million, it is estimated that 50%, or $24 million, of the tax credits would not be allowed immediately but may be used in subsequent tax years and result in a $24 million revenue impact for tax year 2003. Adjusting for the sunset of the Manufacturers' Investment Credit, the revenue impact is estimated to approximate $9 million for calendar year 2006.

In the table above, the NOL and tax credit revenue impacts were combined and then converted to a fiscal-year basis. As discussed above, the estimated revenue impact for the federal NOL limitation is $22 million, and the revenue impact for the federal credit limitation is $9 million for a total revenue impact of $31 million. This total was spread to the following fiscal years: $27 million to 2006-07, and $4 million to 2007-08. Starting with 2007, the estimated revenue gain is reduced to reflect delayed usage of NOLs and tax credits that were limited by this proposal in earlier years.

IRC Section 108-Cancellation of Indebtedness Income

Current law does not specifically address apportioning of debt cancellation for the purposes prescribed by this proposal. According to audit contacts, the method being proposed is current practice among taxpayers and would not, therefore, impact income tax revenues.

LEGISLATIVE STAFF CONTACT

Gail Hall	Brian Putler
Franchise Tax Board	Franchise Tax Board
845-6111	845-6333
gail.hall@ftb.ca.gov	brian.putler@ftb.ca.gov

AB 2998 - APPENDIX A
APPORTIONMENT AND ALLOCATION RULES APPLIED TO EXCLUDED COD